

Message Text

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ACTION EB-07

INFO OCT-01 AF-06 ARA-06 EUR-12 EA-07 NEA-10 IO-11 ISO-00

ERDA-05 AID-05 CEA-01 CIAE-00 CIEP-01 COME-00 DODE-00

FEAE-00 FPC-01 H-02 INR-07 INT-05 L-03 NSAE-00 NSC-05

OMB-01 PM-04 USIA-06 SAM-01 OES-03 SP-02 SS-15 STR-04

TRSE-00 PA-01 PRS-01 /133 W

----- 008990

R 021235Z JAN 76

FM AMEMBASSY BRASILIA

TO SECSTATE WASHDC 3642

INFO AMEMBASSY BELGRADE

AMEMBASSY BUENOS AIRES

AMEMBASSY CAIRO

AMEMBASSY ISLAMABAD

AMEMBASSY KINGSTON

AMEMBASSY KINSHASA

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E.O.11652: N/A

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TAGS: EFIN, ENRG, BR

SUBJECT: CIEC: IMPACT OF HIGHER OIL PRICES ON ECONOMIC DEVELOPMENT

REF: STATE 006381

1. SUMMARY: WITH 80 PERCENT OF ITS DOMESTIC OIL REQUIREMENTS COMING FROM IMPORTS, BRAZIL IS SUFFERING HEAVILY FROM HIGHER OIL PRICES. IN 1974, THE FIRST YEAR AFTER THE PRICE HIKE WAS PUT INTO EFFECT, BRAZIL'S TRADE ACCOUNT REGISTERED A DEFICIT OF \$4.6 BILLION, AS COMPARED TO A VIRTUAL BALANCE IN 1973. THE INCREASE OF \$2.0 BILLION IN THE OIL BILL IN 1974 WAS A MAJOR CONTRIBUTING FACTOR TO THIS DETERIORATION BUT NOT THE SOLE CAUSE. BY 1974 THE ECONOMY WAS FACING SEVERE INFLATIONARY PRESSURES AFTER SEVERAL YEARS OF 10 PERCENT GROWTH RATES. ONE INDICATION OF THIS WAS THE BOOM IN NON-OIL IMPORTS THAT YEAR, SUCH AS IN STEEL, MACHINERY AND EQUIPMENT AND NON-FERROUS METALS. THE OIL PRICE INCREASE THUS CAME ON TOP OF AN ALREADY DELICATE ECONOMIC SITUATION. BECAUSE OF THE BALANCE OF PAYMENTS DIFFICULTIES ENGENDERED BY THE OIL CRISIS AND OTHER FACTORS, BEGINNING IN 1975 THE AUTHORITIES WERE FORCED TO SHIFT THEIR ECONOMIC PRIORITY, EMPHASIZING MORE BALANCE OF PAYMENTS CONTAINMENT AND LESS GROWTH AND LESS INFLATION. AS A RESULT OF THIS REORDERING OF PRIORITIES, BRAZIL WILL HAVE VERY LEAN GROWTH YEARS IN 1976 AND 1977, WITH LITTLE CHANCE OF MEETING THE MAJOR TARGETS OF THE SECOND DEVELOPMENT PLAN WITHIN THE CONTEMPLATED TIME FRAME (1975-79.) END SUMMARY.

2. MERCHANDISE TRADE BALANCE: HIGHER OIL PRICES HAVE HAD A MAJOR NEGATIVE IMPACT ON BRAZIL'S BALANCE OF PAYMENTS . IMPORTING 80 PERCENT (IN 1975) OF ITS TOTAL REQUIREMENTS. BRAZIL IS THE LARGEST NON-OECD IMPORTER OF OIL. ITS OIL IMPORT BILL WENT FROM \$711 MILLION IN 1973, TO \$2.7 BILLION IN 1974 -,\$ 3/:33\$3\$ \$3.0 BILLION IN 1975. ITS TRADE BALANCE F/O/B WENT FROM NEAR BALANCE IN 1972 - 73 TO A DEFICIT OF \$4.6 BILLION IN 1974, SOME 40 PERCENT OF THE DETERIORATION IN THE TRADE BALANCE BEING ATTRIBUTABLE TO OIL. THE OTHER LIMITED OFFICIAL USE

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PART WAS ACCOUNTED FOR BY THE BOOM IN NON-OIL IMPORTS, PARTICULARLY IN STEEL, MACHINERY AND NON-FERROUS METALS. THIS IMPORT BOOM WAS ATTRIBUTABLE TO AN OVERHEATED ECONOMY, WHICH HAD BEEN GROWING AT AN ANNUAL RATE OF 10 PERCENT SINCE 1968 AND WHICH BY 1974 HAD RUN INTO SERIOUS BOTTLENECKS. THERE WAS ALSO A LARGE ELEMENT OF SPECULATIVE BUYING, AS IMPORTERS ATTEMPTED TO HEDGE AGAINST WORLD INFLATION. DURING THE COURSE OF 1975,

THE AUTHORITIES TRIED TO REDUCE IMPORTS BY IMPLEMENTING A TIGHT MONETARY POLICY (IN AN EFFORT TO REDUCE INVENTORIES) BY HIGHER TARIFFS AND AN IMPORT DEPOSIT REQUIREMENT AND BY A SERIES OF ADMINISTRATIVE IMPORT CONTROLS FOR THE PUBLIC SECTOR. THEIR EFFORTS WERE PARTLY SUCCESSFUL AS THE TRADE DEFICIT WAS NARROWED TO AN ESTIMATED \$3.4 BILLION, DESPITE AN ADVERSE TREND IN THE TERMS OF TRADE (SEE BELOW).

3. THE INDIRECT EFFECTS OF HIGHER OIL PRICES, AS THEY AFFECTED BRAZILIAN EXPORTS THROUGH THE SLOWDOWN IN THE WORLD ECONOMY, WERE ALSO SIGNIFICANT. THESE EFFECTS WERE COMPLICATED (I.E., SUGAR AND SOYBEANS) SUFFERED FROM SAGGING PRICES. ALTHOUGH OFFICIAL PROJECTIONS OF EARLY 1975 HAD PREDICTED EXPORTS AT \$10 BILLION (A 25 PERCENT INCREASE OF 1974) BY YEAREND, THE FINAL FIGURE WAS CONSIDERABLY LESS, \$8.7 BILLION. (THE OFFICIAL PROJECTIONS WERE PROGRESSIVELY LOWERED DURING THE COURSE OF THE YEAR.)

4. FINANCING THE DEFICIT: IN RECENT YEARS BRAZIL HAS BEEN SUCCESSFUL IN ATTRACTING FOREIGN FUNDS, BOTH RISK CAPITAL AND BANK LOANS, TO FINANCE ITS TRADITIONAL CURRENT ACCOUNT DEFICITS. (FOR SOME YEARS BEFORE 1974, THESE RESULTED LARGELY FROM SERVICES.) THE LARGE FOREIGN BORROWINGS, HOWEVER, HAVE RESULTED IN A RAPID INCREASE IN THE EXTERNAL DEBT WHICH AT THE END OF 1975 AMOUNTED TO AN ESTIMATED \$22 BILLION. THE QUESTION NOW IS HOW RAPIDLY BRAZIL CAN INCREASE ITS OUTSTANDING DEBT WITHOUT ADVERSE EFFECTS ON ITS INTERNATIONAL CREDIT STANDING: THE GOVERNMENT CLEARLY BELIEVES THAT IT MUST FURTHER REDUCE THE TRADE DEFICIT, AND THEREBY THE CURRENT ACCOUNT DEFICIT, IN ORDER TO MINIMIZE ADDITIONAL INCREASE LIMITED OFFICIAL USE

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IN THE DEBT. WITH THE PICK-UP ON THE WORLD ECONOMY BRAZIL CAN PROBABLY EXPECT SOME IMPROVEMENT IN ITS EXPORT PERFORMANCE BUT THE NEXT SEVERAL YEARS ARE GOING TO BE DIFFICULT. NOT UNTIL MANY OF THE IMPORT SUBSTITUTIONS PROGRAMS NOW PLANNED (SUCH AS IN STEEL, NON-FERROUS METALS, FERTILIZER, PULP AND PAPER, AND CAPITAL GOODS) GAIN MOMENTUM AND EXPORTS ARE FURTHER DIVERSIFIED CAN BRAZIL EXPECT TO OBTAIN RELIEF ON THE TRADE ACCOUNT WITHOUT HAVING TO KEEP GROWTH DOWN.

5. PETROLEUM IMPORTS: WE DO NOT EXPECT THAT THE PETROLEUM IMPORT BILL CAN BE SUBSTANTIALLY REDUCED BEFORE THE END OF THE DECADE, EVEN IF PRESENT DISCOVERIES (PARTICULARLY THE CAMPOS FIELD), STILL IN THE EARLY STAGES OF DEFINITION, TURN OUT

TO BE PRODUCTIVE AND LEND THEMSELVES TO RAPID DEVELOPMENT. IN OTHER
WORDS, A SUBSTANTIAL IMPROVEMENT IN BRAZIL'S PETROLEUM
TRADE ACCOUNT IS NOT IN THE CARDS BEFORE THE
END OF THE DECADE UNLESS WORLD PRICES
DECLINE. BRAZIL HAS LITTLE FLEXIBILITY ON WAYS IT CAN
ECONOMIZE PETROLEUM. ALMOST ALL OF ITS ELECTRICAL ENERGY IS NOW
GENERATED BY HYDROELECTRIC POWER WHILE THE
POOR CONDITION AND LIMITED SCOPE OF THE RAILROAD SYSTEM
AND POOR MASS TRANSIT FACILITIES MAKE PETROLEUM ECONOMIES DIFFICULT
TO ACHIEVE IN THE NEAR TERM.

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6. BRAZIL HAS FOLLOWED A VERY REALISTIC ENERGY POLICY.
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GASOLINE PRICES HAVE BEEN INCREASED VERY SHARPLY (77 PERCENT IN 1975 ALONE), TO DISCOURAGE CONSUMPTION, REFLECT HIGHER OIL IMPORT COSTS, AND GIVE PETROBRAS A SUFFICIENT MARGIN OF PROFIT FOR FURTHER EXPLORATION. THE PRICE OF REGULAR BRAZILIAN GASOLINE (OCTANE RATING SIGNIFICANTLY LESS THAN US REGULAR) IS CURRENTLY ABOUT \$1.35 AT PRESENT EXCHANGE RATES. AS A RESULT, GASOLINE CONSUMPTION ONLY WENT UP 6 PERCENT IN 1975, IN COMPARISON TO 15 TO 20 PERCENT ANNUALLY IN PREVIOUS YEARS, BUT THE AUTHORITIES REMAIN CONCERNED ABOUT EVEN THIS LOWER INCREASE. AS A NEAR TERM SOLUTION, BRAZIL HAS ADOPTED A NATIONAL ALCOLHOL PROGRAM WHICH AIMS AT PRODUCING FOUR BILLION ITRES OF ANHYDROUS ALCOHOL BY 1980, TO BE ADDED TO GASOLINE, WHICH COULD SUBSTITUTE FOR 20 PERCENT OF THE GASOLINE THAT IS PROJECTED TO BE REQUIRED IN THAT YAR. BRAZIL HAS ALSO EMBARKED ON AN AMBITIOUS NUCLEAR PROGRAM BUT THIS PROGRAM WILL NOT HAVE AN IMPORTANT EFFECT BEFORE THE 1980'S AT WHICH TIME IS WILL BEGIN TO COMPLEMENT HYDROELECTRIC POWER. (HYDROELECTRIC POWER RESOURCES IN SOUTHERN BRAZIL WILL HAVE BEE LARGELY DEVELOPED AFTER ITAIPU.)

7. POLICY REACTION: THE INITIAL POLICY REACTION OF THE GOB TO THE OIL PRICE INCREASE WAS ONE OF HOPEFUL EXPECTATIONS. DURING THECOURSE OF 1974, THE POLICY MAKERS MADE ONLY MILD EFFORTS IN TRYINGTO SLOW DOWN ECONOMIC GROWTH IN THE HOPE THAT CONTINUED EXPORT EXPANSION AND CAPITAL INFLOWS WOULD BE SUFFICIENT TO FINANCE THE HIGHER OIL IMPORT BILL. EFFORTS WERE BEGUN TO CULTIVATE MIDDLEEAST MONEY MANAGERS. AS IT BECAME INCREASINGLY DIFFICULT TO INCREASE EXPORTS, AND AS THE FINANCIAL MARKETS TIGHTENED IN THE SECOND HALF OF 1974, HOWEVER, POLICY MAKERS REALIZED THE NEED TO ADOPT REALISTIC POLICIES. THEY THUS ADOPTED A NUMBER OF MEASURES TO CURTAIL IMPORTS, SUCH AS HIGHER TARIFFS AND IMPORT DEPOSITS, AND TO SLOW DOWN ECONOMIC GROWTH DURING 1975. WHILE ADEQUATE FINANCING WAS OBTAINED FROM EUROPEAN AND US MONEY MARKETS TO PREVENT

A DECLINE OF RESERVES BELOW \$4 BILLION BY YEAR-END
1975, LITTLE ARAB PETROLEUM MONEY HAS IN FACT BEEN DIRECTLY OBTAINED.

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8. PRODUCTION AND CONSUMPTION: DFAZIL WAS PARTICULARLY VULNERABLE TO THE JUMP IN OIL PRICES SINCE ITS CONSUMPTION IN RECENT YEARS HAS OUTPACED PRODUCTION. FOR EXAMPLE, FROM JANUARY 1972 THROUGH OCTOBER 1975 MONTHLY PRODUCTION FIGURES HAVE BEEN STEADY AT A LITTLE OVER 5 MILLION BARRELS PER MONTH. THE NATIONAL OIL MONOPOLY, PETROBRAS, HAS INCREASED EXPLORATION EXPENDITURES GRADUALLY FROM A TOTAL OF \$46 MILLION IN 1965 TO \$139 MILLION IN 1973 AND THEN TO MORE THAN \$200 MILLION IN 1974 AND 1975. DESPITE STUDIES REPORTING THAT PROMISING SEDIMENTARY FORMATIONS WHICH MIGHT BE OIL-BEARING DO EXIST IN ONE-THIRD OF THE COUNTRY, PETROBRAS HAS NEVER MADE ANY SIGNIFICANT PROGRESS TOWARD ITS ORIGINAL GOAL OF ACHIEVING DOMESTIC SELF-SUFFICIENCY IN OIL PRODUCTION: AND IN RECENT YEARS IT HAS FALLEN FURTHER BEHIND IN THIS GOAL. FROM 1965 TO 1975 THERE HAS BEEN A GRADUAL DROP IN RESERVES TO PRODUCTION RATION FROM 19 TO 12. IN THE SAME PERIOD DOMESTIC PRODUCTION AS A PERCENT OF TOTAL CONSUMPTION (IN VOLUME TERMS) HAS DECLINED FROM 28 PERCENT TO 20 PERCENT.

9. AMCONGEN RIO REPORTS THAT PETROBRAS FORESEES CRUDE OIL PRODUCTION RISING LESS THAN ONE PERCENT IN 1976 TO 65.6 MILLION BARRELS. THE RESULTS OF POSSIBLE EXPLORATION BY FOREIGN OIL COMPANIES UNDER RISK CONTRACTS ANNOUNCED IN OCTOBER, 1975, AND THE RESULTS OF NEW EXPLORATION BY PETROBRAS WILL NOT BE DEFINITELY KNOWN FOR SOME YEARS. SIMILARLY, USE OF ALTERNATE SOURCES OF ENERGY, EVEN IF THEY PROVE SUCCESSFUL (E.G., BRAZIL HAS ENORMOUS SHALE DEPOSITS), WOULD NOT HAVE A MAJOR IMPACT BEFORE THE 1980'S. THUS, FOR THE REMAINDER OF THE DECADE, BRAZIL WILL CONTINUE TO DEPEND HEAVILY ON IMPORTED OIL AND AT BEST CAN HOPE TO STABILIZE AND SLOWLY REDUCE IMPORT REQUIREMENTS. AT PRESENT EXPORT LEVELS AND OIL PRICES BRAZIL WILL SPEND A THIRD OR MORE OF ITS FOREIGN EXCHANGE EARNED THROUGH EXPORTS TO PAY FOR THIS OIL AND HAS BEEN AND WILL CONTINUE TO CONCENTRATE ITS ECONOMIC POLICIES ON IMPROVING THE BALANCE OF PAYMENTS. THUS THE KEY TO AN IMPROVEMENT IN BRAZIL'S SITUATION HERE WILL DEPEND ON SUCCESSFUL EFFORTS TO RESUME THE EXPANSION OF ITS EXPORTS ON A

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DIVERSIFIED BASIS AND THE CURTAILMENT OF IMPORT REQUIREMENTS
OTHER THAN PETROLEUM THROUGH THE MASSIVE
IMPORT SUBSTITUTION PROGRAMS WHICH WILL HAVE BORNE
FRUIT BY THE END OF THE DECADE.

10. AT THIS POINT IT IS DIFFICULT TO QUANTIFY THE IMPACT
ON GROWTH (AND BALANCE OF PAYMENTS) OF ALL THE
MEASURES TAKEN BY THE GOB TO TACKLE THE HIGHER PRICE
OF OIL. DEPENDING ON THE RATE OF RECOVERY OF THE
GLOBAL ECONOMY AND THE LEVEL OF OIL PRICES THE PRINCIPAL
CONCLUSIONS GENERALLY SPEAKING ARE (A) INVESTMENT AND GROWTH
TARGETS OF THE SECOND DEVELOPMENT PLAN WILL BE STRETCHED
OUT WITH GNP FROWTH IN THE 1975-77 PERIOD LIKELY TO BE,
ON THE AVERAGE, HALF, OR LESS, THAT OF THE 1968-73
PERIOD. (B) SOME DISTORTIONS AND INEFFICIENCIES
MAY DEVELOP IN THE ECONOMY BECAUSE OF REVERSAL OF
BRAZIL'S IMPORT POLICY, INCLUDING THE ADOPTION OF THE
HIGHER TARIFFS AND (C) A TEMPORARY SURGE OF INFLATIONARY
PRESSURES, (IN 1974-75), ALTHOUGH THESE HAVE
NOW LARGELY WORKED THEMSELVES THROUGH THE ECONOMY, AND
ARE BEING BROUGHT UNDER CONTROL AS A RESULT OF THE
GOVERNMENT'S POLICY. (D) THE KEY SECTOR DEVELOPMENT
PROGRAMS, WHICH HAVE A DIRECT BEARING ON THE IMPORT
SUBSTITUTION PROGRAM, ARE GOING FORWARD SO FAR
WITHOUT ANY CHANGE, INCLUDING NEW AMBITIOUS PROJECTS FOR
THE EXPANSION OF THE CHEMICAL INDUSTRIES. IN ESSENCE,
WHAT THE GOB'S MEASURES INDICATE IS THAT BRAZIL HAS
SHIFTED ITS ECONOMIC PRIORITIES TO ONE OVERRIDING GOAL:
THE CONTAINMENT OF THE CURRENT ACCOUNT DEFICIT IN 1976-
77 UNTIL SUCH A TIME AS THE GLOBAL RECOVERY AND
THE FRUITS OF THE IMPORT SUBSTITUTION DRIVE PERMIT THE
RESUMPTION OF A HIGH RATE OF GROWTH.
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Message Attributes

Automatic Decaptioning: X
Capture Date: 01 JAN 1994
Channel Indicators: n/a
Current Classification: UNCLASSIFIED
Concepts: PETROLEUM, ECONOMIC DEVELOPMENT, ECONOMIC REPORTS, PRICES
Control Number: n/a
Copy: SINGLE
Draft Date: 02 JAN 1976
Decaption Date: 01 JAN 1960
Decaption Note:
Disposition Action: RELEASED
Disposition Approved on Date:
Disposition Authority: GolinoFR
Disposition Case Number: n/a
Disposition Comment: 25 YEAR REVIEW
Disposition Date: 28 MAY 2004
Disposition Event:
Disposition History: n/a
Disposition Reason:
Disposition Remarks:
Document Number: 1976BRASIL00868
Document Source: CORE
Document Unique ID: 00
Drafter: n/a
Enclosure: n/a
Executive Order: N/A
Errors: N/A
Film Number: D760038-0921
From: BRASILIA
Handling Restrictions: n/a
Image Path:
ISecure: 1
Legacy Key: link1976/newtext/t19760189/aaaadass.tel
Line Count: 366
Locator: TEXT ON-LINE, ON MICROFILM
Office: ACTION EB
Original Classification: LIMITED OFFICIAL USE
Original Handling Restrictions: n/a
Original Previous Classification: n/a
Original Previous Handling Restrictions: n/a
Page Count: 7
Previous Channel Indicators: n/a
Previous Classification: LIMITED OFFICIAL USE
Previous Handling Restrictions: n/a
Reference: 76 STATE 6381
Review Action: RELEASED, APPROVED
Review Authority: GolinoFR
Review Comment: n/a
Review Content Flags:
Review Date: 24 MAR 2004
Review Event:
Review Exemptions: n/a
Review History: RELEASED <24 MAR 2004 by izenbei0>; APPROVED <24 MAR 2004 by GolinoFR>
Review Markings:

Margaret P. Grafeld
Declassified/Released
US Department of State
EO Systematic Review
04 MAY 2006

Review Media Identifier:
Review Referrals: n/a
Review Release Date: n/a
Review Release Event: n/a
Review Transfer Date:
Review Withdrawn Fields: n/a
Secure: OPEN
Status: NATIVE
Subject: CIEC: IMPACT OF HIGHER OIL PRICES ON ECONOMIC DEVELOPMENT
TAGS: EFIN, ENRG, BR, CIEC
To: STATE
Type: TE
Markings: Margaret P. Grafeld Declassified/Released US Department of State EO Systematic Review 04 MAY 2006